Canada

BC Alberta Saskatchewan

The Western Accord

an agreement between the Governments of Canada, Alberta, Saskatchewan and British Columbia on oil and gas pricing and taxation

ENERGY PRICING AND TAXATION UNDERSTANDING

The Governments of Canada, Alberta, Saskatchewan, and British Columbia are agreed on the need to modify the existing taxation and pricing regime in order to stimulate investment and job creation in the energy sector in Canada and to increase the degree of energy security for all Canadians. The four Governments further agree that these objectives can best be met within a regime of market-sensitive pricing for both oil and gas and within a fiscal regime based on profit-sensitive taxation. To this end, the four Governments agree to replace existing arrangements covering the pricing and fiscal treatment of oil and gas with the provisions set out below. These provisions deal respectively with:

- I Deregulation of Crude Oil Prices
- II Domestic Natural Gas Pricing
- III Fiscal Principles

I DEREGULATION OF CRUDE OIL PRICES

IT IS AGREED that market pricing of oil is desirable and will be implemented as follows:

1. For the purposes of this understanding, 'oil' means crude oil, pentanes plus, synthetic oil and crude bitumen, unless otherwise stated.

2. Oil may be purchased from Canadian or foreign sources without restrictions on volume, and at prices freely negotiated between buyers and sellers, subject to Clauses 5 to 9.

3. The Government of Canada agrees, subject to Clauses 8 and 9, to remove the export charges on oil and petroleum products, the Oil Import Compensation Program and the Petroleum Compensation Charge.

4. Movement of crude oil and petroleum products between provinces, and for import and export purposes, shall be in accordance with federal and provincial legislation established for safety and/or environmental reasons.

5. Concerning the role of the National Energy Board (NEB):

   i. Consistent with the move to market pricing, volume and price restrictions on short-term crude oil and petroleum product exports will no longer be required.

   ii. The NEB will issue non-restrictive licences for short-term exports, on an after-the-fact basis, to permit monitoring of volumes and prices. The NEB will report monthly to the Minister of Energy, Mines and Resources on these oil export matters. Distortions in the competitive market or particular problems associated with a free market which are identified through such monitoring will be addressed by the Minister of Energy, Mines and Resources as they arise, following consultation with provincial governments.

   iii. The NEB will, in appropriate instances, ensure that export contracts for periods exceeding one month contain force majeure clauses.

   iv. Longer-term exports, of more than one year for light crude and petroleum products and two years for heavy crude (as defined by the NEB) will continue to require prior approval of the NEB and the Governor-in-Council.

   v. The NEB's practice of allocating light crude oil among eastern Canadian refineries will be discontinued.

6. The producing provinces shall retain their power to control production of crude oil to ensure good conservation practice or, in the event of market constraints, to ensure equitable sharing of production.

7. Consistent with the spirit of deregulation, the Alberta Petroleum Marketing Commission will cease to act as the exclusive agent for the marketing of the Crown lessees' share of crude oil and pentanes and will, in its role as buyer and seller of oil in Alberta, be in competition with buyers and sellers of oil in the private sector.

8. In the event that supplies of crude oil and petroleum products to Canadian consumers are significantly jeopardized, the federal government, after consultation with producing provinces, may restrict exports to the extent it considers necessary to ensure adequate supplies to Canadians.

9. In the event of international oil market disturbances that result in sharp changes to crude oil prices, with potentially negative impacts on Canada, the Government of Canada, following consultations with provincial governments, will take appropriate measures to protect Canadian interests.

10. These principles, effecting oil price deregulation for Canada, will come into effect on June 1, 1985.

II DOMESTIC NATURAL GAS PRICING

IT IS AGREED that a more flexible and market-oriented pricing mechanism is required for the domestic pricing of natural gas. It is recognized that a new domestic pricing regime that is equitable to the producing, transporting and distributing components of the industry, and is acceptable to producing and consuming provinces, requires extensive consultation with the interested parties. To facilitate this consultation and develop a new market-sensitive pricing system it is agreed that:

1. The Alberta border price will remain at its present level pending the introduction of a new domestic natural gas pricing regime on or before November 1, 1985.

2. A task force of senior officials from the federal government and the producing provinces will work with all interested parties, including consuming provinces and industry, to develop a more flexible market-sensitive pricing mechanism on or before November 1, 1985.

3. The subsidy of TransCanada PipeLines tariffs under the federal Transportation Assistance Program will be terminated in conjunction with the elimination of the Canadian Ownership Special Charge.

4. The Natural Gas Market Incentive Plan under which Alberta producers provide a price discount to industrial customers in eastern Canada will be extended for one year until April 30, 1986.

5. The Market Development Incentive Payments by the Province of Alberta to the Government of Canada will terminate following payments for gas delivered up to April 30, 1986, or to a maximum level of $160 million in additional payments, whichever comes first.

III FISCAL PRINCIPLES

IT IS AGREED that changes to the fiscal regime for the petroleum industry are needed:

- to promote industry investment which furthers energy security and economic growth; and
- to ensure that the producing industry is taxed on the basis of profits rather than revenues.

Consistent with these objectives, it is agreed that the following measures will be implemented as soon as is possible:

1. The Government of Canada will remove the following taxes or charges: the Natural Gas and Gas Liquids Tax (which includes the Natural Gas Export Levy), the Incremental Oil Revenue Tax, the Canadian Ownership Special Charge, the Crude Oil Export Charge and the Petroleum Compensation Charge.

2. The Government of Canada will not introduce any special tax on the oil and gas producing industry in order to recover the deficit in the Petroleum Compensation Account.

3. The Petroleum Incentives Program will terminate one year from the date of announcement of this understanding. Notwithstanding this termination, there will be 'grandfathering' arrangements for existing Exploration Agreements.

4. (a) For new production of oil, natural gas and gas liquids on or after April 1, 1985, the Petroleum and Gas Revenue Tax will not apply. Further, subject to federal approval, the Petroleum and Gas Revenue Tax will not apply to natural gas or oil consumed by or produced by major new energy projects undertaken on or after April 1, 1985.

   The PGRT levied on prior production will be phased out according to the following schedule:

PERIOD	EFFECTIVE TAX RATE (%)	
	Conventional Oil and Gas	Synthetic Oil
January 1/86 - December 31/86	10.0	6.0
January 1/87 - December 31/87	8.0	4.0
January 1/88 - December 31/88	6.0	2.0
January 1/89 and thereafter	0	0

   (b) In addition to the small producer's credit, the first $10 000 of an individual's resource income will not be subject to the Petroleum and Gas Revenue Tax.

   (c) The current EOR fiscal regime will continue to apply.

5. The parties to this understanding agree that the phase-out of the PGRT is required to enhance the producing industry's capability to reinvest in the development of new oil and gas resources for all Canadians. Canadian security of supply requires that a high level of reinvestment occur. The federal and producing governments expect such reinvestment will occur and will pursue an active program of monitoring industry reinvestment to ensure that Canada's energy security objectives are realized.

6. To assist companies which are not currently paying corporate income tax, the Government of Canada will allow new exploration and development write-offs which are not immediately usable under the federal corporate income tax to reduce the Petroleum and Gas Revenue Tax otherwise payable. The reduction will be calculated as 30 per cent of the unused amount of write-offs related to new expenditures in the year. The reductions will be applied to PGRT payable on both production income and resource royalty income, for corporations only, and will be taken after the 'small producer credit' calculation.

7. The Government of Canada agrees that tax-based incentives designed to stimulate investment in Canada's oil and gas industry shall be of general application to the industry without discrimination as to the location of the activities in question or as to ownership and control.

8. The Government of Canada will consult with the maritime provinces and Territorial governments on appropriate royalty incentives to help spur frontier petroleum investment.

9. The parties to this understanding agree that the benefits resulting from aforementioned changes to the federal tax regime shall flow through to the oil and gas industry. The parties also agree that any net benefits resulting from crude oil price decontrol, as determined by their respective jurisdictions, shall flow through to the industry. The calculation of the net benefits shall take into account the termination of the crude oil export charge.

10. The parties to this understanding reserve the right, as resource owners, to establish and adjust from time to time their royalty and incentive systems for the development of oil and gas within their respective jurisdictions. Such adjustments, including changes to APIP, shall be consistent with the objective expressed above of flowing through to industry the net benefits of the fiscal and price decontrol changes agreed to herein.

BACKGROUNDER

CRUDE OIL PRICE DEREGULATION

Canada has had a system of administered oil prices since September, 1973. Under this system, the domestic price of crude oil has been maintained below its international market value. This system is now being dismantled.

From June 1, 1985, producers of oil will negotiate sales contracts directly with crude oil purchasers and the market will determine the price of oil.

With deregulation, buyers of crude will have access to a choice of sources to benefit consumers. Equally, producers will have access to different outlets for their crude.

The system now being dismantled began in 1973 with the freezing of domestic prices of all crude oil. In order to attract investment in new supplies of oil, 'new oil' was granted international prices. This was first applied in 1978 to production from the Syncrude synthetic oil plant at Mildred Lake, Alberta, and later to output of synthetic oil from the Suncor plant. Then, from January 1982, it applied to oil discovered after December 31, 1981. Gradually, the categories of qualifying oil were expanded to include oil discovered from 1974 through 1981.

To deliver these special pricing arrangements, complex government-administered programs were added to the oil import compensation system started in 1974.

The administered oil pricing system has reached the point in 1985 where more than 50 per cent of the oil produced in Canada receives the international price. Including imports, more than 80 per cent of oil consumed in Canada receives some form of compensation. The resulting system of levies, taxes and regulations has imposed serious restrictions on petroleum markets. The system has inhibited the petroleum industry in meeting its full potential for creating jobs and stimulating economic renewal.

Also in 1973, controls were imposed on oil exports to reflect the requirements of the domestic price control regime and to address international oil market developments. All oil exports were subject to licence, issued by the National Energy Board, imposing volume, price and other restrictions on the terms of export contracts. Export charges were levied to make up the difference between controlled domestic prices and those available in export markets.

An improved international oil supply environment, falling Canadian consumption, growing western productive capacity and the increasing cost to the economy of requiring industry to hold back output, has resulted in some relaxation of export controls over the last few years. Currently, Canada exports approximately 29 thousand cubic metres (180 000 barrels) per day of light crude and 42 thousand cubic metres (265 000 barrels) per day of heavy crude. Nevertheless, the system of export charges and licences remained in place, with negative consequences both for the petroleum industry and the economy.

Export charging and licensing provided a disincentive to the development of export markets for Canadian oil by industry. Furthermore, because Canadian oil is subject to government controls rather than strictly commercial considerations, it has tended to sell at a discount in foreign markets. This factor, combined with administered domestic crude oil prices, has generated serious pricing anomalies. Recently, Canadian crude oil has had to be exported at prices substantially below those paid by domestic refineries.

Canada — indeed the world — is in a different position in 1985 than it was a decade ago with respect to energy security. International and national mechanisms for emergency preparedness have been created. Productive capacity exceeds demand. Energy alternatives abound. If international oil market disturbances cause

sharp changes in crude oil prices, which could have a negative impact on Canada, the federal government will take appropriate measures to protect Canadian interests after consulting with provincial governments.

Freed from unnecessary government controls, the oil industry can find new reserves of conventional oil, and develop and upgrade the vast resources of heavy crude oil and bitumen. But this cannot be done at controlled prices. And, it cannot be done by governments restricting market access.

With deregulation the NEB will no longer determine the prices of exported oil. Nor will the NEB require prior approval of light crude and oil product export contracts of less than one year and heavy crude oil export contracts of less than two years. However, the board will continue to monitor these exports and report to the Minister of Energy, Mines and Resources on a monthly basis. Exports of a longer duration will not be possible without government approval. The government will continue to monitor volumes and prices to ensure its awareness of events in the marketplace that could pose warning signs to the Canadian economy.

The above measures on oil exports and domestic pricing will mean several significant changes to the petroleum industry in Canada. These are summarized in the attached table.

	Old Administered System	Market System
Petroleum Compensation Charge (PCC)	- All domestic and foreign crude oil and imported petroleum products consumed in Canada bore the PCC, currently at $41.14 per cubic metre. - Exports of products were eligible for rebates of the PCC.	- No longer imposed.
Petroleum Levy Offset Program (PLOP) for Petro-Chemical Producers	- The last increase in the Petroleum Compensation Charge was $17.50 per cubic metre on November 10, 1984 (as announced in the Economic Statement of November 8, 1984). - PLOP provides an offset against that increase for certain primary petrochemical products.	- Program ends with elimination of PCC.
Primary Industry Levy Offset Program	- As part of the Fuel Tax Rebate Program those in primary industries (farmers, fishermen, and those involved in logging, mining, hunting and trapping) are eligible for a 1.8¢ per litre PCC rebate.	- The 1.8¢ per litre PCC rebate ends with elimination of PCC. - The 3.0¢ per litre Federal Sales Tax rebate continues.
Controlled Prices on Conventional Old Oil (COOP)	- The price of oil discovered prior to 1974 is controlled by agreement with the provinces at below world levels. - About 45 per cent of domestic oil is affected.	- Producers sell their oil at market price. - Refiners pay market price. - Government does not set the price.
New Oil Reference Price (NORP) for Synthetic Crude Oil	- Producers of synthetic crude eligible for the international price and receive compensation based on a complex calculation similar to that employed for conventional new oil.	- Price set by marketplace, not by government. - No compensation required.

	Old Administered System	Market System
New Oil Reference Price (NORP) for Conventional Crude Oil	- Producers of qualifying new oil in five producing provinces and the territories are paid compensation for difference between international price and controlled domestic price. - Compensation based on 81 different NORP prices calculated from prices of 54 foreign crudes at Montreal, subject to detailed federal-provincial administrative manual.	- Producers sell their oil at market price. - Refiners pay market price. - Government does not set the price or pay any compensation.
Oil Import Compensation Program (OICP)	- Payments made to oil importers based on the difference between the average cost of foreign and equivalent-quality Canadian crude oil at Montreal. - To protect markets for Canadian production, access to international market was restricted.	- No import compensation necessary. - No restrictions on imports.
Domestic Transfer Compensation	- Compensation granted for costs of moving domestic crude to refineries east of Montreal.	- Such movements will be on a commercial basis.
Crude Oil Export Charge	- A charge is recommended by the National Energy Board on all exported crude oil and petroleum products. The level is equal to the difference between the selling price and the lower Canadian-controlled price. - Export charge revenues on crude oil split 50-50 with the province of production. - The revenues on products accrued entirely to the federal government.	- Export charges eliminated.

	Old Administered System	Market System
Crude Oil Export Licences	- NEB licence required for all crude oil exports and for most petroleum products.	- Monitoring of exports will continue but prior approval will not be required for exports of light crude oil and petroleum products less than one year, and heavy crude less than two years, in duration.
Import Licences	- NEB licences required on imports of heavy fuel oil.	- No licences required.

85/37 (b)

BACKGROUNDER

NATURAL GAS PRICING

Since 1975, the prices of Alberta natural gas sold in Saskatchewan, Manitoba, Ontario and Quebec have been administered under agreements between the governments of Canada and Alberta. During this period, natural gas prices were linked to crude oil prices.

From 1975 to 1981 gas prices were set at about 85 per cent of crude prices; from 1981 to the end of 1984 the relationship was 65 per cent. However, the natural gas industry and gas consumers have argued to governments that a pricing system that links gas prices to oil prices is inflexible, and that a pricing regime that is responsive to natural gas market conditions is necessary.

Canada and the producing provinces have now agreed to develop, together with consuming provinces and the natural gas industry, a market-responsive pricing system to be implemented on or before November 1, 1985. The objective is to allow prices to be negotiated between buyers and sellers of natural gas.

Interim Pricing

For the interim period, April 1 to November 1, the governments of Canada and Alberta have agreed to freeze the Alberta Border Price of gas at its current level of $2.79 per gigajoule. The current wholesale price of gas in eastern Canada is $3.86 per gigajoule. With the Alberta Border Price frozen, and the elimination of the Canadian Ownership Special Charge on natural gas (see below), the current wholesale price of gas in eastern Canada is expected to decrease somewhat.

Market-Sensitive Pricing

For the longer term, governments have agreed to establish a task force of senior officials to advise on the implementation of a market-sensitive system for natural gas pricing by November 1 of this year.

The task force will rely on assistance from representatives of the gas industry from both the producing and consuming sectors. As well, the governments of consuming provinces will be consulted to assure that their views are incorporated into the new gas pricing system.

The intention is to establish, on or before November 1, 1985, a natural gas pricing system that will be responsive to conditions in the marketplace.

Natural Gas Marketing Incentive Program

In certain industrial markets where natural gas faces stiff competition from alternative fuels, the governments of Alberta and Canada implemented, early in 1984, the Natural Gas Marketing Incentive Program. Under this scheme, gas producers pay up to $0.35 per gigajoule to encourage load retention and the development of incremental industrial markets east of Alberta. The governments

have agreed to continue this program for one more year, until April 30, 1986, at which time it is expected that whatever incentives are required to retain and expand industrial gas markets will be established through buyer-seller negotiations.

Transportation Assistance Program

In February 1984 the federal government implemented the Transportation Assistance Program (TAP), which reduces the cost of transporting Alberta natural gas to eastern markets. This program will continue at its present level of $0.057 per gigajoule until the Canadian Ownership Special Charge (COSC) of $0.14 per gigajoule is removed. When the COSC and TAP are eliminated, wholesale prices will therefore fall approximately $0.08 per gigajoule.

Market Development Incentive Payments

Under previous agreements, the federal government administers four programs to develop and expand markets for Alberta gas. These programs are funded by payments out of wellhead revenues called Market Development Incentive Payments (MDIP). The federal government has spent $192 million under these programs, and has made firm commitments to spend an additional $110 million over the next two years. However, payments to date under MDIP total only $142 million, leaving a deficit of $160 million. The governments of Canada and Alberta have agreed that the MDIP system will continue to April 30, 1986, or until the $160 million has been paid to the Government of Canada, whichever comes first.

Natural Gas and Gas Liquids Tax (NGGLT)

The NGGLT was introduced in 1980 on the production of all natural gas and natural gas liquids, including natural gas exports. The rate and base of this tax have changed a number of times over the last few years. Because of the formula, the current rate stands at zero. The Government of Canada will remove this tax entirely.

BACKGROUNDER

FISCAL MEASURES

The energy pricing and taxation agreement between the Government of Canada and the governments of Alberta, British Columbia and Saskatchewan will provide important benefits to the petroleum industry and to all Canadians. The agreement will encourage energy security and economic growth in Canada by stimulating investment in the oil and gas industry, thereby allowing the industry to make its full contribution to the economy. Federal taxation of the petroleum industry will also be made more profit sensitive. Legislation to implement the agreed fiscal changes will be introduced as soon as possible.

Existing Taxes

The Government of Canada has agreed to remove the following taxes or charges introduced by the previous federal government: the Natural Gas and Gas Liquids Tax, the Incremental Oil Revenue Tax, the Canadian Ownership Special Charge, Export Charges on both product and crude exports and the Petroleum Compensation Charge.

Petroleum Incentives Program

The Petroleum Incentives Program (PIP) will continue for one more year until March 31, 1986. PIP will then be terminated except for eligible exploration expenses incurred in drilling frontier wells required to satisfy existing commitments related to existing Exploration Agreements on the Canada Lands. These eligible frontier wells will continue to qualify for PIP during a further grandfathering period which will extend to no later than December 31, 1987.

Petroleum and Gas Revenue Tax (PGRT)

The current rate of PGRT is 16 per cent, with an effective rate, after the resource allowance where applicable, of 12 per cent on conventional oil and gas and 8 per cent (to the end of 1985) on synthetic oil. Approved enhanced oil recovery (EOR) projects are able to deduct eligible capital costs against project revenues, thus permitting elimination of PGRT until the project attains payout.

Under the terms of the agreement, the PGRT is to be totally eliminated by January 1, 1989. In addition, the PGRT will not apply to approved major new energy projects or to any new production of conventional oil, natural gas or natural gas liquids brought on stream after April 1, 1985.

The PGRT will be phased out for existing production according to the following schedule of effective rates:

	Conventional	Synthetic
	(%)	
January 1, 1986	10	6
January 1, 1987	8	4
January 1, 1988	6	2
January 1, 1989	0	0

Under this schedule, the rate of PGRT will be cut in half in about two and a half years and eliminated a year later.

A more precise definition and mechanisms for administering a PGRT exemption for new production will be worked out, in consultation with the industry and producing provinces, over the next few weeks.

Individual Exemption

The existing Small Producers' Credit was increased in the November 8 Economic Statement to $500 000 per year. As a result of this agreement, the Government of Canada has agreed to further reduce the burden of the PGRT on individuals by making the first $10 000 of income exempt from the tax. This will mean that an estimated two thirds of those individuals who are currently paying PGRT will no longer be required to do so.

Enhanced Oil Recovery Projects

The current EOR regime will continue. New enhanced recovery projects will have the option of current EOR regime treatment, or new oil treatment, as described in the annex to the agreement.

PGRT Offsets

Many smaller aggressive oil and gas companies are unable to use their income tax write-offs on a current basis because they do not yet have sufficient revenues from production. To assist these types of firms, which are typically smaller Canadian companies, the Government of Canada will allow new exploration and development write-offs, which are not immediately usable under the federal corporate income tax, to be used to reduce PGRT otherwise payable. This reduction will be calculated as a nonrefundable credit against their PGRT, at a rate of 30 per cent of the unused write-offs associated with new expenditures in the year.

In order to minimize administrative complexity and taxpayer burden, this offset will be voluntary (i.e., taken at the discretion of the taxpayer). Use of this offset provision will allow the taxpayer to 'cash in' his unused exploration and development deductions.

These offsets will, at least in part and for the next few years, serve as a replacement for PIP for those companies which cannot fully use income tax write-offs.

Nondiscriminatory Incentives

Any new tax-based federal incentives designed to stimulate oil and gas industry investment will be nondiscriminatory in terms of location and ownership. This is not intended, however, to prohibit present or future tax measures of general application to all industries such as the Investment Tax Credit. Neither is it intended to prevent the introduction of specific incentives targetted at particular forms of high-cost production.

Canada Lands Royalties

In view of the major fiscal changes such as PIP and PGRT elimination that are part of this agreement, the Government of Canada will consult with the governments of interested provinces and territories to modify the Canada Lands royalty regime in such a way as to help maintain an appropriate level of petroleum exploration and development activity. Possible royalty modifications to be examined include holidays, rate reduction and revised structures.

Industry Reinvestment

The Government of Canada has agreed to make substantial pricing and fiscal changes in order to provide additional funds for industry reinvestment. A high level of investment is essential to ensure security of energy supply for Canadians and to create more jobs. Based on historical industry performance and extensive discussion with the industry, it is expected that all of the additional cash flows generated by the measures announced today will be reinvested.

To ensure that high levels of reinvestment take place, the parties to the agreement will be actively monitoring industry behaviour. For its part, the Government of Canada will instruct the Petroleum Monitoring Agency to pursue a more intensive program of monitoring industry investment behaviour.

Provincial Flow-Through

The governments have agreed that each of the producing provinces will flow through to the oil and gas industry the net benefits that might otherwise be received as provincial revenues resulting from the following changes:

- crude oil price decontrol;
- phase-out and removal of federal taxes;
- introduction of federal 'offsets' against PGRT; and
- removal of federal and Alberta PIP.

The estimation of these net benefits will be determined by each provincial government for its respective jurisdiction.

Any changes in provincial royalties or incentives will remain completely within the jurisdiction of each province but will be consistent with the agreed principle of flow-through of net benefits from the changes outlined above.